Moody's Investors Service

Credit Research
New Issue
13 OCT 2000

NEW ISSUE : California (State of)

MOODY'S ASSIGNS Aa2 RATING TO STATE OF CALIFORNIA GO BONDS

State
CA

Moody's Rating

ISSUE		RATING
General Obligation Bonds		Aa2
Sale Amount	$850,000,000	
Expected Sale Date	10/17/00	
Rating Description	General Obligation Bonds	
General Obligation Refunding Bonds		Aa2
Sale Amount	$148,000,000	
Expected Sale Date	10/17/00	
Rating Description	General Obligation Bonds	

Opinion

NEW YORK, Oct 13, 2000 -- Moody's has assigned a rating of Aa2 to the general obligation bonds of the State of California. The general obligation bonds to be sold on October 17th are being used to retire commercial paper notes issued to finance various state and local capital facilities projects, investments in public schools and higher educational facilities, and various clean air and transportation improvement projects. The rating reflects the strength and diversity of a state economy that is positioned well for future expansion, the state's improved financial condition, including the rebuilding of cash and budget reserves to record levels, improved financial management, and increased attention to debt management issues. These strengths are tempered by the state's relatively inflexible budget structure, due in large part to education expenditures mandated by Proposition 98; its potentially volatile revenue structure during periods of economic weakening; the lack of a formal mid-year spending adjustment mechanism; and the negative impact a stock market correction could have on capital gains tax collections. In addition, the state's significant infrastructure needs put pressure on its moderate debt position, although developing debt management policies offer the potential for managing debt levels successfully. The state's credit outlook is stable.

The Aa2 rating is based on the following credit considerations.

STATE ECONOMIC GROWTH OUTPACES NATION AND CONTINUES TO EXCEED CONSENSUS FORECASTS

Over the last three years, the state has enjoyed healthy gains in both employment and personal income, outpacing the nation as measured by these two economic indicators. Economic growth in California and the U.S. exceeded consensus forecast estimates for 1999, as the state posted employment gains of 2.8% and growth in personal income was the strongest realized by the state since 1988. The healthy growth in both jobs and personal income contributed to strong taxable retail sales performance in 1999. Such sales grew by 9.3% last year, reflecting, in inflation-adjusted terms, the most rapid growth in retail sales the state has enjoyed since the early 1980's.

The state's continued expansion in 2000 helped drive the state's unemployment rate to 4.8% in April 1999. And through August, non-farm employment has increased by more than 279,000, outpacing the gains realized through the same period in 1999. While the Services sector continues to account for a significant portion of overall job growth, the state continues to enjoy positive job growth across all major industry sectors except manufacturing. Through the first eight months of 2000, total manufacturing employment remained relatively flat, ending a two-year period of net job losses. The end of the decline for the sector can be attributed to the rebound of high-tech manufacturing, which is offsetting continued contraction in non-

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to increased employment growth for the state beyond current forecasts.
S BUFFER AGAINST REVENUE VOLATILITY
improved the state's financial condition, driving cash and budget reserves to record levels. While the targeted
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The state ended fiscal 1999 with total borrowable resources of $8.7 billion, including a $1.255 billion balance
its Special Fund for Economic Uncertainties (SFEU). Combined with an ending general fund cash balance of
of nearly $850 million, the $9.6 billion in available resources was the most the state has had on hand in over

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The increased diversity of the economy has positioned the state well for future expansion, and the deep customer base of the high technology sector decreases the likelihood of a statewide economic downturn absent a national recession. Consensus economic forecasts call for the state's economy to remain strong and to continue to outpace the nation. Consistent with its historical practice, the state's official economic forecast for the near term remains at or below these forecast estimates.

Moody's anticipates the state's economy will continue to outperform the nation over the next two years. With some Asian economies beginning to post positive economic gains, there is upside potential for the state's economic and revenue forecast. Any gains above the marginal economic growth that is forecasted by the state for Asia would undoubtedly have a beneficial impact on state exports, and would lead to increased employment growth for the state beyond current forecasts.

UNPRECEDENTED CASH POSITION PROVIDES BUFFER AGAINST REVENUE VOLATILITY

The economic growth over the last several years has dramatically improved the state's financial condition, driving cash and budget reserves to record levels. While the targeted budget reserve remains moderate at 2.2% of general fund revenues, other internal funds are available to provide a buffer against volatile revenue performance during periods of economic downturn.

The state ended fiscal 1999 with total borrowable resources of $8.7 billion, including a $1.255 billion balance in its Special Fund for Economic Uncertainties (SFEU). Combined with an ending general fund cash balance of nearly $850 million, the $9.6 billion in available resources was the most the state has had on hand in over two decades. At the beginning of fiscal year 2000, the state projected it would end the year with $9.1 billion in available resources, after its $1 billion Revenue Anticipation Note repayment. Based on continued strong growth in revenues, the state ended the year with more than $17 billion in available resources. This dramatic increase can be attributed to the 19% growth in personal income tax revenues, reflecting continued strong growth in capital gains tax collections. These sizable balances provide a moderate buffer against the state's historic revenue volatility during periods of economic downturns, a product of its economically sensitive tax structure.

The state currently estimates that it will end the current fiscal year with internal borrowable resources totaling more than $12 billion, eliminating the need for an annual cash-flow borrowing for the first time in over two decades.

DESPITE GROWTH, FISCAL 2001 BUDGET REFLECTS CONTINUING FISCAL CONSERVATISM

The fiscal year 2001 budget was signed into law on June 30, 2000, the second consecutive year the state budget was enacted on time. As previously stated, the state has enjoyed sizable revenue growth over these last two years, due in large part to unprecedented growth in capital gains and stock option income which far exceeded all projections. But despite a nearly $9 billion revenue windfall in the prior fiscal year, the state resisted efforts during the fiscal 2001 budget debate to spend the bulk of such unanticipated resources on recurring expenses.

General fund expenditures for the current fiscal year are $11 billion higher than fiscal 2000 levels. However, this figure includes $2 billion in one-time tax relief and approximately $5 billion in one-time capital expenses that largely could be scaled back if revenue collections do not meet budget estimates. The state has based its current year budget on conservative revenue estimates, including the assumption that the stock market will not realize the same type of gains in 2000 as it did in 1999. Thus, the state does not expect stock option income will reach 1999 levels. Revenue collections through the first two months of the current fiscal year are nearly $500 million above forecast, indicating that the state will comfortably exceed its estimates for the current fiscal year absent any major unanticipated economic slowdown.

Changes in the approach to budget management has positioned the state to better weather cycles more successfully, despite its volatile revenue structure and inflexible spending base. These include cautious revenue forecasts which avoid committing the most volatile part of the revenue base to fixed expenses, improved reserve levels, and deploying revenue windfalls to one-time investments that improve the state's readiness for future revenue stress.

FUTURE CAPITAL NEEDS LIKELY TO INCREASE DEBT BURDEN, HIGHLIGHTING ROLE OF MULTI-YEAR CAPITAL PLANNING PROCESS

The state's economic and financial improvement over the last several years, and the moderation of debt issuance for prison construction, have led to an improvement in its debt ratios. While they are still above the national medians, the difference between the state's ratios and the national medians has narrowed. As reflected in our 2000 Debt Medians Report, California's net tax-supported debt per capita and debt as a percentage of personal income rank 19th and 22nd, respectively.

Currently, debt service represents approximately 3.74% of state general fund revenues. The state's long-term debt capacity is strongly affected by general fund revenue volatility, and the scale of capital needs facing the state highlight the need for the state to adopt a multi-year capital planning process. Such a formal process would enable the state to adequately address its long-term infrastructure needs without limiting budgetary flexibility, especially during periods of weakening economic and revenue performance.

Outlook

The rating outlook for the state is stable. In the near to medium term, the economy is projected to continue to grow, and will continue to outpace the nation. While the state's economic forecast does not anticipate a rebound in the Japanese economy in the near term, any improvement beyond the marginal growth currently assumed will have a beneficial impact on state exports. Moody's expects the state to continue to conservatively manage its finances, thereby maintaining current healthy fund balances. And given the scale of capital needs, the debt burden is likely to grow, further highlighting the importance of new plans to institute a formal multi-year capital planning process.

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